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Prudential Financial, Inc. (PRU)

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MANAGEMENT DISCUSSION SECTION

Operator: Ladies and gentlemen, thank you for standing by, and welcome to Prudential's Quarterly Earnings Conference Call. At this time, all participants have been placed in a listen-only mode. Later, we will conduct a question-and-answer session, instructions will be given at that time. [Operator Instructions] As a reminder, today's call is being recorded.

I will now turn the call over to Mr. Bob McLaughlin. Please go ahead, sir.

Bob McLaughlin

Head-Investor Relations, Prudential Financial, Inc.

Good morning, and thank you for joining our call. Representing Prudential on today's call are Charlie Lowrey, Chairman and CEO; Rob Falzon, Vice Chairman; Andy Sullivan, Head of US Businesses; Scott Sleyster, Head of International Businesses; Ken Tanji, Chief Financial Officer; and Rob Axel, Controller and Principal Accounting Officer. We will start with prepared comments by Charlie, Rob, and Ken, and then we will take your questions.

Today's presentation may include forward-looking statements. It is possible that actual results may differ materially from the predictions we make today. In addition, this presentation may include references to non-GAAP measures.

For a reconciliation of such measures to the comparable GAAP measures and the discussion of factors that could cause actual results to differ materially from those in the forward-looking statements, please see the slide titled Forward-Looking Statements and Non-GAAP Measures in the appendix to today's presentation and the quarterly financial supplement, both of which can be found on our website at investor.prudential.com.

And now I'll turn it over to Charlie.

Charles F. Lowrey

Chairman & Chief Executive Officer, Prudential Financial, Inc.

Thank you, Bob, and thanks to everyone for joining us today. Our second quarter financial results reflect the impact of macroeconomic environments, including the unusual confluence and magnitude of rising interest rates, widening credit spreads, and equity market declines. In addition, we strengthened our individual life reserves as part of our annual review of assumptions, which had a significant impact on our results. This was primarily driven by an increase in our guaranteed universal life reserves.

As a reminder, we discontinued single life guaranteed Universal Life sales in 2020 as part of our strategy to derisk our product mix and we continue to make strategic progress in transforming our businesses to be less market-sensitive and more nimble.

We also made additional investments to enhance our long-term sustainable growth. We did this in several ways. First, we significantly reduced our market sensitivity by completing our planned divestitures. Second, we invested in growth businesses and partnerships to address customer needs and expand access to our products and solutions. And third, we continued to advance our cost savings program and now expect to reach our $750 million target one year ahead of schedule.

We executed on these strategic initiatives with the support of our solid balance sheet. Our strong financial position provides us with the flexibility to navigate through the current macroeconomic conditions, while continuing to invest in the long-term growth of our businesses and return capital to shareholders. We're also confident that our higher rate environment will benefit our businesses over time despite the short-term impacts on our financial performance.

I'll now provide an update on the progress of our strategic initiatives. Turning to slide 3. We're executing on our plans to reposition the businesses by reducing market sensitivity and making investments to support long-term sustainable growth. We completed the sales of our full service business and a portion of our traditional variable annuities in April. Together, these divestitures resulted in a $1.5 billion pre-tax gain and further reduced the overall market sensitivity of our businesses by approximately 20%.

Moving to our growth investments. We are investing in programmatic acquisitions and partnerships that will help us grow in emerging markets and expand access to investing, insurance and retirement security around the world.

In Africa, we completed our acquisition of an initial minority stake in Alex Forbes, a leading provider of financial advice, retirement, investment and wealth management in South Africa. We are now in the process of increasing our stake in the company by up to an additional 18% through a tender offer.

In June, we established a partnership with Mercado Libre, the largest e-commerce platform in Latin America with approximately 200 million users. This will enable us to deliver life insurance and accident and health products, tailored to the platform's mass market customer base.

At the same time, we are investing in the growth of our products that meet the evolving needs of our customers. Our FlexGuard buffered annuity product recently surpassed $10 billion in sales since launching two years ago. We are also experiencing strong sales from our more recently launched FlexGuard Income offering.

Turning to our cost savings initiative on slide 4. We now expect to achieve our full $750 million cost savings target in 2022, one year ahead of schedule. We recorded $175 million in cost savings during the second quarter for a total of $725 million of run rate savings to date since 2019. We've also implemented a process of continuous improvement to identify and execute on additional cost savings opportunities in the future.

Turning now to slide 5. Our robust balance sheet is at the core of all our efforts to transform Prudential to be a leader in expanding access to investing, insurance and retirement security around the world. This financial strength also provides the flexibility to balance investing in our businesses with delivering attractive returns to our shareholders.

Our robust financial position includes a high-quality, well-diversified investment portfolio, our capital position supports a AA financial strength rating and we had $7 billion in highly liquid assets at the end of the second quarter.

During the second quarter, we returned over $800 million to shareholders. And since the beginning of 2021, we have returned a total of $6 billion towards our objective of $11 billion by the end of 2023.

Finally, a comment on the environmental, social and governance front. In June, we published our third Annual Sustainability Report, which details the progress of our ESG initiatives, including information on our EEO-1 and pay equity disclosures, commitments to racial equity and achieving net-zero emissions. We believe in transparency and hold ourselves accountable to the commitments detailed in our report.

With that, I'll turn it over to Rob for an update on our business performance.

Robert Michael Falzon

Vice Chairman, Prudential Financial, Inc.

Thank you, Charlie. I'll provide an overview of our financial results and business performance for our PGIM, US and International businesses. I'll begin on slide 6 with our financial results for the second quarter of 2022. Pre-tax adjusted operating income was $872 million or $1.74 per share on an after-tax basis and included a $1.4 billion increase in reserves from our annual assumption update and other refinements.

We strengthened our Individual Life reserves, primarily reflecting updates to policyholder behavior and revised mortality assumptions. These updates were based on several industry studies; emerging practices and our own experience, following our well-established annual assumption update process.

Current quarter results also included an $852 million gain from completing the sale of PALAC, a legacy block of Variable Annuities.

Our GAAP net loss was $1.4 billion lower than our after-tax adjusted operating income, primarily driven by the mark-to-market impact from higher interest rates on derivatives that are used for asset liability management, partially offset by a gain on the full – on the sale of our full service business.

Turning to the operating results of our businesses, excluding the impacts of the annual assumption update and the gain on the sale of PALAC. PGIM, our global investment manager, reported lower other related revenues driven by a decrease in seed and co-investment income and incentive fees, as well as lower asset management fees compared to the year ago quarter.

Results of our US businesses were lower than the year ago quarter, reflecting lower spread income due to less favorable variable investment income and lower fee income resulting from the decline in equity markets, partially offset by more favorable underwriting.

The decrease in earnings in our International businesses primarily reflected lower earnings from joint venture investments, lower net investment results driven by less favorable variable investment income and less favorable underwriting results, partially offset by business growth.

Turning to slide 7. PGIM, our global active investment manager, has diversified capabilities in both public and private asset classes across fixed income, alternatives, real estate and equities. PGIM's long-term investment performance remains attractive with 75% to 85% of assets under management outperforming their benchmarks over the last 3, 5 and 10-year periods.

PGIM benefited from its diversified business mix, as strong institutional net inflows of $8.1 billion, primarily driven by fixed income, offset retail outflows as investors repositioned their portfolios in a rising rate environment. As the investment engine of Prudential, the success and growth of PGIM and of our US and International insurance and retirement businesses are mutually enhancing.

PGIM's asset origination capabilities, investment management expertise and access to institutional and other sources of private capital are a competitive advantage, helping our businesses bring enhanced solutions, innovation and create more value for our customers. Our insurance and retirement businesses in turn, provide a source of growth for PGIM through affiliated flows and unique access to insurance liabilities that complement its successful third-party track record of growth.

PGIM's average fee rate increased due to the successful execution of our strategy, including the continued mix shift toward higher fee strategies in our alternatives and private credit business. As a result, asset management fees decreased by only 6% despite assets under management declining by 11% due to rising rates, widening spreads and equity market depreciation.

We continue to grow our alternatives and private credit business, which has assets under management of approximately $230 billion across private credit, real estate equity and debt and private equity secondaries and benefits from our global scale and market-leading positions.

Notably, across PGIM's private platform, we deployed nearly $15 billion of capital, up nearly 40% from the year ago quarter, reflecting the continued strong environment for private credit. PGIM also raised nearly $3 billion in new private capital commitments across real estate and private credit.

Turning to slide 8. Our US businesses produced diversified earnings from fees, net investment spread and underwriting income and benefit from our complementary mix of longevity and mortality businesses. We continue to shift our business mix towards higher growth and less market-sensitive products and businesses to transform our capabilities and cost structure and to further expand our addressable markets.

Retirement Strategies achieved solid sales in the second quarter across its institutional and individual lines of business. Institutional stable value sales were $1.6 billion. International reinsurance closed $1.4 billion of longevity reinsurance transactions during the quarter, and US pension risk transfer closed several transactions totaling more than $725 million.

Our product pivots in individual retirement have resulted in strong sales of more simplified solutions with nearly $1.5 billion of FlexGuard and FlexGuard Income sales in the second quarter. Our strong FlexGuard sales benefited from implementing a fully digital and automated new business experience. This tech-forward approach helps to maintain our record pace of sales.

Our Individual Life sales also reflect our earlier product pivot strategy, with variable life products representing approximately 71% of sales for the quarter. The improved group insurance benefits ratio for the quarter reflects the transition from a pandemic to an endemic phase of COVID, as well as favorable experience in both group life and disability.

In addition, we're focused on creating the next generation of financial solutions to serve the diverse needs of a broader range of customers and clients. This quarter, we launched the Prudential simplified issue final expense product on the Assurance platform.

Turning to slide 9. Our International businesses include our Japanese life insurance companies, where we have a differentiated multi-channel distribution model, as well as other businesses aimed at expanding our presence in high-growth emerging markets.

In Japan, we are focused on providing high-quality service and expanding our geographic coverage and product offerings. Our needs-based approach and mortality protection focus continue to provide important value to our customers, as we expand our product offerings to meet their evolving needs.

And we continue to enhance customer experience and agent support, including through digital tools. For example, this quarter, Gibraltar launched an exclusive website dedicated to teachers to help serve this market.

In emerging markets, we are focused on creating a carefully selected portfolio of businesses in regions where customer needs are growing, where there are compelling opportunities to build market-leading businesses and where the Prudential enterprise can add value.

In the second quarter, we continued to focus on expanding product and business capabilities in emerging markets to meet the evolving needs of customers. In Brazil, we achieved record sales, driven by the expansion of our third-party distribution channel, where sales increased 120% compared to the year ago quarter, as well as by the continued strength of the Life Planner channel.

We established a partnership with Mercado Libre in Latin America to expand access to customers in the region. In the first two weeks following the launch in June, we have sold Life and A&H policies in every state in Brazil. This was accomplished through a fully digital sales, customer service and claims experience.

We also continue to expand our wellness platform across Latin America by establishing a partnership with Medifé, a health service provider to 300,000 customers in Argentina. In addition, we are expanding our presence in Africa through an investment in South African-based Alex Forbes, as Charlie discussed earlier.

As we look ahead, we're well positioned across our businesses to be a global leader in expanding access to investing, insurance and retirement security. We continue to invest in growth businesses and markets, deliver industry-leading customer experiences and create the next generation of financial solutions to better serve the diverse needs of a broad range of customers.

And with that, I'll hand it over to Ken.

Kenneth Yutaka Tanji

Chief Financial Officer & Executive Vice President, Prudential Financial, Inc.

Thanks, Rob. I'll begin on slide 10, which provides insight into earnings for the third quarter of 2022 relative to our second quarter results. As noted, pre-tax adjusted operating income in the second quarter was $872 million and resulted in earnings per share of $1.74 on an after-tax basis.

To get a sense for how our third quarter results might develop, we suggest adjustments for the following items. First is an adjustment for two one-time items that net to a charge of $571 million in the second quarter. Our annual assumption update and other refinements resulted in a net charge of $1.4 billion, primarily driven by our Individual Life business, as Rob previously described. This was partially offset by a $852 million gain from the sale of a block of legacy variable annuities.

Next, variable investment income outperformed expectations in the second quarter by $80 million. Third, we adjust underwriting experience by a net $25 million. This adjustment includes a placeholder for COVID-19 claims experience in the third quarter of $50 million for our International businesses, primarily due to hospitalization benefits for policyholders recovering from COVID-19 at home in accordance with the special regulatory provision in Japan that is currently in effect.

We have also updated our mortality assumptions for the US businesses to include continued COVID-19 mortality with an expected gradual transition to an endemic phase over time. While we have attempted to reflect COVID-

19-related claims experience, the actual impact will depend on a variety of factors such as infection and fatality rates, geographic and demographic mix, and the effectiveness of vaccines.

And last, we expect other items to be $30 million lower in the third quarter, primarily due to lower than typical expenses in the second quarter that were partially offset by lower other related revenues in PGIM and lower joint venture earnings. These items combined get us to a baseline of $2.63 per share for the third quarter.

I'll note that if you exclude items specific to the third quarter, earnings per share would be $2.75, a modest decline primarily due to lower fee income as a result of market depreciation, lower underwriting income due to the updated actuarial assumptions, and continued COVID-19 mortality that is now reflected in our US businesses expected results. While we have provided these items to consider, please note there may be other factors that affect earnings per share in the third quarter.

Turning to slide 11. I will now comment on the upcoming adoption of the new accounting standard for long-duration insurance contracts, also known as LDTI, which goes into effect on January 1, 2023. The new accounting standard applies to our GAAP financial statements and will have no direct effect on our statutory financial statements, cash flows or dividend capacity.

We estimate that adjusted book value, which excludes accumulated other comprehensive income, or AOCI, will be reduced by $1 billion to $2 billion as of December 31, 2021. This reflects the reclassification of non-performance risk gains from retained earnings to AOCI and other changes in reserves.

We believe adjusted book value, which excludes AOCI, remains a relevant measure as AOCI and GAAP equity will continue to lack symmetry in the valuation of invested assets and insurance liabilities.

We estimate that AOCI will be reduced by approximately $28 billion to $33 billion as of December 31, 2021, primarily due to the remeasurement of long-duration liabilities with a lower discount rates, primarily in our Japan business.

Also of note, GAAP equity and adjusted book value will continue to exclude certain unrealized insurance margins from products subject to LDTI. As of December 31, 2021, the estimated after-tax unrealized insurance margins related to those products are expected to be $60 billion to $65 billion, primarily in our Japan business. These margins represent an important factor in determining financial strength.

Turning to slide 12. We continue to maintain a robust capital position and adequate sources of funding. Our capital position continues to support a AA financial strength rating and we have substantial sources of funding. Our cash and liquid assets were $7 billion and above our $3 billion to $5 billion liquidity target range, due to the receipt of proceeds from the sales of our full service retirement business and a block of legacy variable annuities and other sources of funds include free cash flow from our businesses, as well as contingent capital facilities.

Turning to slide 13 and in summary, we are executing on our plans to reposition our businesses. We are expecting to reach our targeted cost savings one year ahead of plan and our rock-solid balance sheet provides financial flexibility to execute on our transformation and thoughtfully deploy capital.

Now I'll turn it to your operator for questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] Our first question today is coming from Tom Gallagher from Evercore. Your line is now live.

Thomas Gallagher
Analyst, Evercore ISI

Q

Good morning. I'd like to start on the mortality assumption review, the charge. Can you talk a little bit about what drove it? Was it more the mortality side? Was it more the lapse side? Was it mainly mortality assumptions pre-pandemic? Was there a meaningful adjustment from the experience that you've seen through the pandemic? A little bit of color there would be helpful? Thanks.

Kenneth Yutaka Tanji
Chief Financial Officer & Executive Vice President, Prudential Financial, Inc.

A

Yeah. Hey Tom, it's Ken. Let me give you a little bit of background on the assumption update. As I think most people know, each year in the second quarter, we examine our updated experience that's available from our own business, but we also look at information that's available from industry studies and other surveys.

And again, this year, we followed our process that's quite comprehensive and well established. We did make updates to our individual life insurance actuarial assumptions, primarily for policyholder persistency and mortality. Let me start with the policy persistency changes, that was mainly with our guaranteed Universal Life products, where we lowered our lapse and surrender assumptions and that revision reflected information, we gained from recently released studies and surveys, as well as our recent emerging experience.

And so, we essentially refined into a more dynamic lapse assumptions for that portion of the business. In terms of mortality, we also included the impact of COVID-19 claims with the expectation of shifting from endemic to – or from a pandemic to endemic phase. And we also lowered future mortality improvement, as well given recent trends. Now the majority of the reserve strengthening was the result of the policyholder persistency assumption. The mortality updates were more modest and across all of our businesses.

Thomas Gallagher
Analyst, Evercore ISI

Q

That's really helpful, Ken. Appreciate that color. My follow-up is just, will the – will this also result in a statutory impact in addition to the GAAP impact? And if so, can you help quantify that and talk about how that could impact capital management, if at all?

Kenneth Yutaka Tanji
Chief Financial Officer & Executive Vice President, Prudential Financial, Inc.

A

Yeah. The updated assumptions are applied to our statutory reserves as well. It will have a comparable magnitude of impact, but we're well positioned to maintain strong regulatory capital ratios. We have a strong capital position overall, and we continue to have diverse sources of free cash flow going forward as well.

Operator: Your next question is coming from Ryan Krueger from KBW. Your line is now live.

Ryan Krueger
Analyst, Keefe, Bruyette & Woods, Inc.

Q

Hi, thanks. Good morning. Would you expect much of an impact from updated Q2 factors for longevity risk, which I don't think was in the RBC ratio previously and an updated mortality risk factor when that is implemented, I believe, which may be at year-end?

Kenneth Yutaka Tanji
Chief Financial Officer & Executive Vice President, Prudential Financial, Inc.

A

Yeah. Ryan, it's Ken again. I'll take those. No, we don't expect a significant overall impact for either of those. The longevity factors were incorporated, I believe, last year and including some correlation benefits between longevity and mortality and given the updated – the updates to mortality that have been proposed, those will be manageable and again, reflective of the good combination of business that we have that is both longevity-based and mortality-based.

Ryan Krueger
Analyst, Keefe, Bruyette & Woods, Inc.

Q

Got it. Thanks. And then I had a question on the Bermuda subsidiary that you had established earlier this year and contributed capital to last year – or last quarter. Can you give any more color on kind of what your longer-term plans are for that? And what – to what extent you may be able to start shifting US Business into Bermuda to get an offsetting benefit from the capital you had contributed last quarter? Thanks.

Kenneth Yutaka Tanji
Chief Financial Officer & Executive Vice President, Prudential Financial, Inc.

A

Okay. Yeah, Ryan, yes. The – we did launch a new company last quarter. It's a new reinsurance company that's based in Bermuda, which we call LOTUS Re. We think it's a really good capability to have. We've reinsured a block of variable life policies to that company. We're obviously following the BMA standards. The business is well reserved and capitalized, including the capital that we put in, in it last quarter. But it's also very well aligned with the economics of that business. So, going forward, we do believe this will be a more efficient capital framework for our Variable Life business that's well aligned with the economics of that business as well.

Operator: Thank you. Our next question is coming from John Barnidge from Piper Sandler. Your line is now live.

John Barnidge
Analyst, Piper Sandler & Co.

Q

Thank you very much. Can you maybe talk about persistency trends in group life and visibility? There's been increased lapse activity seen by other market participants, given kind of the movements in the war on talent among employees. It looks like persistency did go down in 2Q for disability, but not life. Thank you.

Andrew F. Sullivan
Executive Vice President & Head-US Business, Prudential Financial, Inc.

A

Hey, John, good morning, it's Andy. I'll take your question. Maybe I'll bring it up a level and say that the general effect that we saw during the pandemic was companies really pulled back on switching their benefit plans.

As we've come through the pandemic and as hopefully we're coming out the other side, and it's becoming more endemic, we've seen, basically, in the marketplace, a normal level of RFP activity. So, things have gotten sort of back to normal.

When we talk about our persistency, we're very pleased with our persistency results. And as you would imagine, we track very closely the profitability of the business that we retain versus the profitability of the business that we lose.

And part of the secret sauce of managing group insurance businesses is, sometimes addition by subtraction. If we can't get the rates that we want to get to move a case to profitability, we – our plan and our intention and our follow-through is always to let it go. But we're quite pleased at the persistency levels in the business.

John Barnidge
Analyst, Piper Sandler & Co.

Q

Great. Thank you very much. And then, my follow-up question, if I may. That unrealized insurance margin in Japan, is that a gain that can be harvested through a risk transfer? Or how should we be thinking about Pru realizing those?

Kenneth Yutaka Tanji
Chief Financial Officer & Executive Vice President, Prudential Financial, Inc.

A

Yeah. Hey, John, it's Ken. Let me just – the unrealized insurance margin is – that we're referencing here and have quantified is under the GAAP constructs. And you can think of it as basically the present value of future premiums less the amounts of the premiums needed to provide claims – to provide for claims. So, it's margin above and beyond what's needed to support the expected claims.

It is indicative of the profitability of the business, and the majority is from our Japan business, and it's reflective of what we think is the strong profitability of our Japan business. It's – there is good embedded profits there and value, and it is a potential source of free cash flow over time. And if we choose to reinsure a block of it as well, we could release capital that way.

Operator: Thank you. Our next question is coming from Elyse Greenspan from Wells Fargo. Your line is now live.

Elyse Greenspan
Analyst, Wells Fargo Securities LLC

Q

Hi. Thanks. My first question, going back to Individual Life. When we normalize for the assumption review, VII and underwriting, it looks like the underlying earnings power of that segment is in the range of $100 million. And I think in the slides, you guys put the Q3 baseline at $96 million. So can you talk about if there are any ongoing earnings impact from the assumption review? And is roughly $100 million pre-tax a good quarterly level run rate earnings for that segment?

Andrew F. Sullivan
Executive Vice President & Head-US Business, Prudential Financial, Inc.

A

Yeah, Elyse, this is Andy. I'll take your question. The assumption update does have an ongoing impact on our Individual Life business. It reduces our core earnings capability in the neighborhood of $30 million per quarter. So, our core run rate was about $105 million before, so it brings it down to $75 million.

What you're seeing in our walk on the slide, remember that we expect to have $20 million of higher underwriting gains seasonally in third quarter of 2022. So, if you make that adjustment, that gets you to that $96 million baseline.

Elyse Greenspan
Analyst, Wells Fargo Securities LLC

Q

Okay. Thank you. And then my second question is on Assurance IQ, if you guys can just give us some color on the upcoming enrollment season. And then revenues declined there roughly 30% in the second quarter. Were revenues, for some reason, impacted by the assumption review? Or should we just think about that $78 million perhaps indicating a lower baseline for that segment?

Andrew F. Sullivan
Executive Vice President & Head-US Business, Prudential Financial, Inc.

A

Yeah, Elyse, it's Andy. I'll take the question. Let me start by reiterating that we're still very focused on scaling up revenue in each of the distinct product lines in the Assurance IQ platform, as that really is what's required to get the business to achieve profitability.

With that said and you sort of pointed to this, there are a number of things that are important to discuss this quarter as we've made really good progress in Medicare Advantage that was somewhat masked. First, we did have a $17 million negative LTV adjustment, that is a direct impact on revenue, that was an adjustment – assumption adjustment based on our persistency.

Second, we saw an impact on the under 65 healthcare business versus the year ago quarter as the Biden administration did not open up a special enrollment period like they did last year. Those two factors really masked a 64% improvement in Medicare Advantage enrollments and a resulting 35% increase in Medicare Advantage commission revenue versus a year ago quarter.

So, we are pleased with the continued underlying fundamental strengthening in the Medicare Advantage product line. The first part of your question is, how we're feeling about our preparation. We're making very good progress in becoming ready for the fourth quarter open enrollment season from an agent preparedness perspective specifically. We've now – we'll be entering our third year, so we have the benefit of two full cycles underneath us. And candidly, we're seeing great success in hiring agents, partly due to the difficult time that some of the smaller players in the space are having.

Operator: Thank you. [Operator Instructions] Our next question is coming from Jimmy Bhullar from JPMorgan. Your line is now live.

Jimmy S. Bhullar
Analyst, JPMorgan Securities LLC

Q

Hi, good morning. I just had a question first on the actuarial review and its impact on future income. I think, you mentioned $120 million on GAAP. Should we assume a commensurate impact on stat income going forward as well?

Kenneth Yutaka Tanji
Chief Financial Officer & Executive Vice President, Prudential Financial, Inc.

A

It would have a similar impact on GAAP earnings. I'm not – we'll have to get back to on the quantum of that, but there would be a future impact of strengthening the reserves going forward.

Jimmy S. Bhullar
Analyst, JPMorgan Securities LLC

Q

Okay. And then can you talk about your – the decline in the Life Planner count and Gibraltar Life consultants and whether it's sort of – and what your expectations are for growth in both of those agency channels? Is the decline being caused more by sort of COVID-related factors right now or should we assume modest growth going forward in both of those?

Scott Garrett Sleyster
Executive Vice President & Head-International Business, Prudential Financial, Inc.
A

Hi, Jimmy, this is Scott. The LP count has been essentially flat with new recruits roughly offsetting LP resignations and our LC count has actually been slightly negative. As you might expect, it's been more challenging to recruit in a pandemic environment. It's actually a little bit harder to mentor new hires in this kind of environment. We expect this situation to remain challenging until the pandemic eases. But we would then expect to see improvement in kind of a return to normal beyond the pandemic. I think, it's also worth noting that we continue to focus a great deal of energy on expanding our third-party distribution channels across all of our markets.

Operator: Thank you. Next question is coming from Suneet Kamath from Jefferies. Your line is now live.

Suneet Kamath
Analyst, Jefferies LLC
Q

Thanks. Just wanted to come back to the assumption review and the impact on statutory. Just given the size of the charge, does this suggest that you're going to need to infuse capital into PICA or is there enough excess RBC in there to sort of absorb the similar charge that you took on a GAAP basis?

Kenneth Yutaka Tanji
Chief Financial Officer & Executive Vice President, Prudential Financial, Inc.
A

Yeah, overall this will be very manageable, as I mentioned, where we think we're well positioned to maintain strong RBC statutory ratios. And right now, we're not expecting to have to infuse additional capital as a result.

Suneet Kamath
Analyst, Jefferies LLC
Q

Okay. Got it. And then I guess for, Charlie, I'll ask the same question I always ask on the strategy. And this idea of improving the earnings contribution from growth businesses to over 30%, it still seems like you'll need pretty sizable inorganic M&A to get there.

So, just curious, what you're seeing out there in the landscape? Are you seeing opportunities to put some of the $7 billion of liquid assets at the holding company to work? I mean, just thinking about inorganic growth, what are you seeing out there? Thanks.

Charles F. Lowrey
Chairman & Chief Executive Officer, Prudential Financial, Inc.
A

Yeah, sure. We are seeing – we're seeing a number of different opportunities. At this point in the cycle, you're beginning to see other things or some things free up that wouldn't have been there before and at reduced multiples. So, it's a good time to have flexibility in order to be able to think about that kind of acquisition.

What I would say is, I'll make a couple of observations. The first is our strong balance sheet provides us with the flexibility to manage through whatever macroeconomic conditions we may face as we look forward. And that's going to be an important consideration for us as we go forward.

But second, to your point, having a strong balance sheet in dislocated market means that we can take advantage of opportunities that present themselves. So, we're going to be – we do have a strong balance sheet. And we're going to remain flexible with that balance sheet, and we're going to look for opportunities that may present themselves in the current economic environment.

Operator: Thank you. Next question is coming from Alex Scott from Goldman Sachs. Your line is now live.

Alex Scott
Analyst, Goldman Sachs Q

Hi, first question I had was on the Annuities business. Now that the transaction is closed, I was just wondering if you could help us think through earnings power there and just given a lot of moving parts to the transaction, equity markets. And then I think, maybe, the runoff of the block, how should we think of that over the next several quarters?

Andrew F. Sullivan
Executive Vice President & Head-US Business, Prudential Financial, Inc. A

Sure, Alex...

Kenneth Yutaka Tanji
Chief Financial Officer & Executive Vice President, Prudential Financial, Inc. A

Go ahead, Andy. All right. Sorry about that. Maybe I'll just comment. The – we did close the PALAC transaction. And it was – it came in as we were expecting and would reduce our earnings by about $75 million a quarter, and that is very consistent with what we had announced at the time of the transaction.

Andrew F. Sullivan
Executive Vice President & Head-US Business, Prudential Financial, Inc. A

Yeah, Ken, maybe I'll just jump in and add. I just may bring it up a level back to our intentional strategy to reduce our exposure to traditional variable annuities with guaranteed living benefits to be less than 10% of our enterprise earnings. And so, that reduction is very intentional, and it was the two-step process of pivoting and runoff, that remains on track.

We saw $2.9 billion in runoff this quarter. And then, obviously, the de-risking transaction. But the other major part of that was pivot to our FlexGuard chassis, a more simpler design, less volatile design. And we're certainly pleased with the continued strength of those sales.

Alex Scott
Analyst, Goldman Sachs Q

Got it. And the second one I had for you was on the LDTI. You gave some good disclosure on the book value impact. And I know you mentioned that there's a lot of margin that's sort of left in the reserve, because of the pivot sort of approach to LDTI. What does that mean to the earnings power? Can you help us think through that, particularly in Japan, where it's a lot of [indiscernible] (39:39), I assume that a lot of that margin probably has to do with that business? Will this materially change the earnings power?

Kenneth Yutaka Tanji
Chief Financial Officer & Executive Vice President, Prudential Financial, Inc. A

Yes. Overall – and we'll be providing more disclosure around the whole transition to the new accounting standard as we – around the time that it is implemented. But let me provide some overall thoughts on earnings. First, overall, we don't expect a significant impact on the level of core operating earnings.

Certain businesses have little or no impact like PGIM and Group Insurance. And from our insurance and retirement businesses in the US and internationally, some will be a bit higher, some will be a bit lower. But overall, that's generally offsetting. So again, overall, we don't expect a significant change in the level of our core operating earnings.

Operator: Thank you. Next question today is coming from Tracy Benguigui from Barclays. Your line is now live.

Tracy Benguigui
Analyst, Barclays Capital, Inc.

Q

Good morning. I have another question on the assumption update you mentioned industry study. We're in the [indiscernible] (40:54). Is that something that is widely available or if you could provide context regarding who participated in that study and who conducted the study, that would be very helpful.

Charles F. Lowrey
Chairman & Chief Executive Officer, Prudential Financial, Inc.

A

Yeah. Tracy, that was done by a private party. And it did involve a number of people in the industry. We're not at liberty to disclose who was in there. That's proprietary information of the study. So, that's about what I can tell you.

Tracy Benguigui
Analyst, Barclays Capital, Inc.

Q

Okay. Got it. Also noticed that your corporate expenses were low in the quarter compared to the baseline you provided last year. And I'm just wondering how you're thinking about the full year $1.65 billion guidance.

Kenneth Yutaka Tanji
Chief Financial Officer & Executive Vice President, Prudential Financial, Inc.

A

Yes. During the quarter, we did have some favorable items. We did have an FX gain that was helpful this quarter. We did have some other lower expenses. And then there is some timing. And we do expect to have seasonally higher expenses in the second half of the year. But given where we are in the first half, we would expect to be modestly below the $1.65 billion guidance that we originally gave.

Operator: Thanks you. Our next question is coming from Jack Matten from Wolfe Research. Your line is now live.

Jack Matten
Analyst, Wolfe Research LLC

Q

Hi, good morning. I wanted to ask on the investment portfolio. Are there any metrics you can provide regarding new money rates relative to current portfolio yields? And then what percentage of the portfolio turns over on average in a given year?

Robert Michael Falzon
Vice Chairman, Prudential Financial, Inc.

A

Jack, it's Rob. I can provide that for you. In the – if you compare the new money rates to our portfolio yields, they're up about 20 basis points in the US and 50 basis points in terms of a positive spread in Japan. So, the rise in rates means we're no longer having a drag on our earnings when we measure our new money rates against that portfolio yield. In terms of rollover, it's somewhere between 5% and 10% on an annual basis.

Jack Matten
Analyst, Wolfe Research LLC

Q

Got it. Thank you. And then, just a question on the drivers and the outlook for net flows in the PGIM business. And clearly, this quarter, there was a strong recovery in institutional flows, with some pressure on retail flows. I guess could you just talk about what's driving some of the divergence across those customer types and maybe your outlook moving forward?

Andrew F. Sullivan
Executive Vice President & Head-US Business, Prudential Financial, Inc.

A

Yes, Jack, it's Andy. I'll take your question on flows. As we've talked about in the past, flows at PGIM will vary quarter-to-quarter. So, we stay very focused on the long-term track record.

In Q2, third-party net flows were roughly flat, as very strong institutional inflows of $8.1 billion were offset by the retail outflows of $8.3 billion. Let me give you some color on that. So, the $8.1 billion of institutional inflows represented our best quarter since 2018, and those flows were positive across every geography that we operate in.

The real drivers were we continue to see clients, their algorithms, institutional clients' algorithm shifting into fixed income as the rates rise. And we also see those clients continuing to seek yield in our privates and alternatives strategies.

On the retail side, I would say the story is we were impacted like the rest of the industry by headwinds in the active fixed income and growth equity space. The industry experienced $305 billion in outflows across active US mutual funds as individual investors continued to reposition.

Every top 10 fixed income manager and nine of the top 10 active growth equity managers posted negative flows. So, but despite that environment, our PGIM investments moved up to the number 16 US Mutual Fund family in the quarter by assets under management.

I'll end the way I typically do, which is we're confident that we're going to be a net flow winner over time. As we look at our business, we have a broad and diversified product portfolio. We continue to put up very strong long-term investment performance, and we have great distribution. So, we'll continue to build on our track record of 18 of the last 19 years of positive flows, and we're quite proud of that.

Operator: Thank you. Next question is coming from Mike Ward from Citi. Your line is now live.

Michael Augustus Ward
Analyst, Citigroup Global Markets, Inc.

Q

Thanks guys. Just wanted to follow-up on Suneet's question about the transformation. And I think you touched on your strategy in terms of acquisitions. But to his point, it seems like that would require a very decent chunk of inorganic growth.

So, I guess just wondering, should we assume from here that the strategy is primarily around organic growth acquisitions or opportunistic buys? Or do you still look at material kind of divestments or reinsurance from your existing business mix?

Charles F. Lowrey
Chairman & Chief Executive Officer, Prudential Financial, Inc.

A

Yes. This is Charlie. Let me take that one. It's going to be a combination of both, right? Because in the – as we've done in the past, we're going to continue to be thoughtful about the deployment of proceeds, especially in light of the macroeconomic conditions. And we've always said we're going to be good stewards of capital.

But we're going to – what we're going to do is to continue to demonstrate a disciplined, a consistent and a balanced approach to the redeployment of capital within our businesses for acquisitions and to our shareholders, while fulfilling a commitment to our financial strength by maintaining a strong balance sheet.

So, we're going to look at a combination of, again, investment in our businesses, acquisitions, returns to shareholders, but also divestitures if they make sense. And we've always said we'll look at additional divestitures of blocks of business, but only if they make sense. And that's what we're going to do as we go forward. So, it will be – we'll get to our goals through both addition and potentially subtraction, but it has to make sense on both sides for shareholders.

Michael Augustus Ward
Analyst, Citigroup Global Markets, Inc.

Q

Okay. Thanks very much. And so I guess, kind of relatedly, it sounds like a pretty comprehensive review in the Life business, just thinking about some of the difficulties that segment has faced over the last few years. I guess, does this have any impact on your strategic view of the Life business? It almost seems like at this point, even if you were to sell it or offload it at a loss, it might be beneficial? Or is the diversification benefit, the mortality longevity offset? Is that important to the extent that you're going to hang on to Life? Thanks.

Charles F. Lowrey
Chairman & Chief Executive Officer, Prudential Financial, Inc.

A

Yeah. Let me start, and then Andy, you may want to add some commentary on it. But for the Life business, we still think there's a significant potential for growth in the industry. You have a $12 trillion insurance – life insurance gap, you have increasing sales as shown by last year's industry, with sales being the best they have been in about two decades.

And from an enterprise perspective, the Life business continues to be a really helpful component in balancing our longevity with our mortality. So, there's a lot of interconnection with the other businesses along with PGIM, and it's a business that we would like to remain in. But we'll do so very, very carefully as we go forward. Andy?

Andrew F. Sullivan
Executive Vice President & Head-US Business, Prudential Financial, Inc.

A

Yeah, Charlie, I would just add that we've had a very explicit strategy that we remain committed to, and the path forward is clear. We recognize the disappointing and volatile aspects of GUL. But remember that our strategy has been about pivoting and de-risking the business.

We see selling GUL – single life GUL in the third quarter of 2020 and we began to rotate the product portfolio towards simpler designs, inclusive of variable Universal Life, final expense and simply term. We also have been very much leaned into reducing expenses to make the business more efficient.

So as we're doing that, we're seeing the new business sales, where we have a lot of pricing power. And we like the positive returns of that block of business that we're putting on, and we're filling that gap that Charlie talked about.

Operator: Thank you. We've reached the end of our question-and-answer session. I'd like to turn the floor back over to Mr. Lowrey for any further or closing comments.

Charles F. Lowrey

Chairman & Chief Executive Officer, Prudential Financial, Inc.

Okay. Thank you very much. And thank you for joining us. We've made significant progress reducing our market sensitivity, while investing in sustainable long-term growth, advancing our cost savings program and returning capital to shareholders.

Looking ahead, we are confident that our strategy, along with our solid financial position will help us deliver an even more meaningful difference in the lives of our customers and delivering value to all our stakeholders, including providing attractive returns to our shareholders, while enabling us to fulfill our vision to become a global leader in expanding access to investing insurance and retirement security. Thank you again for joining us and for your time today.

Operator: Thank you. That does conclude today's teleconference and webcast. You may disconnect your line at this time, and have a wonderful day. We thank you for your participation today.